MEDC Response and Background on Michigan Economic Growth Authority (MEGA) Tax Credit Program; the OAG Audit Report and the Senate Finance Committee Audit Hearing on May 4, 2010

MEGA was established in 1995 as Michigan's response to interstate competition for the jobs and investment of businesses seeking to grow in Michigan. Companies were eligible for tax credits if they met specific requirements to create jobs, pay agreed upon wages and execute their growth in Michigan. Due to the requirements of the program, most companies that were awarded tax credits were well established manufacturing companies with long operating experience and solid financial histories.

In order to receive the tax credits, Companies were required to annually submit a tax credit certificate application reporting the number of jobs, the wages paid and any other requirements established in their tax credit agreements. The annual tax credit certificates were reviewed by MEGA staff and, if the company met the statutory and credit agreement requirements, a tax credit was issued by MEGA.

With legislative changes that were made beginning primarily in 2000, the program began to expand by adding additional types of MEGA Tax Credits, including retention tax credits and high-technology tax credits. With these changes, the portfolio of companies with MEGA tax credits began to increase and more types of businesses became involved with the program.

An audit process was not put in place when MEGA became law in 1995 because it was not seen by the administration at the time as business friendly and would be a burden for companies to go through an annual audit process when the MEDC had well established relationships with these companies. MEDC's team of business development managers met with these companies annually and had a good understanding of the projects being implemented by the company. It also should be remembered that the backbone of all taxes in this state and the nation is built on the notion of honesty and self reporting of the taxpayer. To presume that since the MEDC/MEGA was not performing audits from 1995-2005 that Michigan companies were cheating on MEGA tax credit forms and thereby committing tax fraud, is simply ludicrous and those that make this argument are really only so doing to attack the MEGA program on a philosophical basis or for political gain.

In 2006, MEDC recognized the need to begin to perform bi-annual sample auditing of MEGA recipients. MEDC took steps to reassign staff to complete these activities and samplings of tax credit filings from 2003, 2004, and 2005 were audited. A large sample population was selected, representing 66 companies and 71 MEGA credits, most for multiple tax years. Each company was required to provide payroll and other records to support the annual summary tax credit application data provided by the company but not to the level of reviewing each individual payroll record that we are doing today. On-site visits occurred. Results of the audit were compiled and shared with the Department of Treasury. In late 2008, MEDC decided to do random audits on an annual basis instead of every two years. The MEDC then selected a sample of companies representing 33 companies of 113 (29%) with 2007 tax credit filings and embarked on an audit process in February 2009, which included data gathering from companies, and in-depth analysis of the tax credit filing. During the process of conducting this audit, the OAG also began a performance audit of the MEGA tax credit program, starting in June 2009.

In May of 2009, the MEDC management made a decision to undertake a full audit of all the tax credits issued for the 2006, 2007, 2008 and 2009 tax years beginning in Fiscal Year 2010. This would include a 100% audit of all the companies receiving tax credits in those years with tax credit certificates issued prior to January 1, 2010. Staff was reassigned and began a portion of the audit work in the summer of 2009. The100% auditing work would begin in October 2009. In total, this included 130 companies and 349 tax year filings. Due to the volume of the audit, the MEDC issued an RFP to Michigan CPA firms to assist with the process. That contract has been awarded and through April 30th, the MEDC and/or CPA firm have completed 51 audits with the goal of having all audits completed by September 30, 2010.

Any audits that reveal a variance are being forwarded to the Department of Treasury on a quarterly basis, which was the interval requested by Treasury. The Department of Treasury has indicated that they will seek to recover any variance identified in the audit processes.

In 2009, the MEDC also designed and implemented a new pre-audit process which all companies will utilize for tax credits requested after January 1, 2010. The new pre-audit process includes an enhanced MEGA tax credit certificate application which provides detailed company information on wages, hours worked and weeks worked for each employee in the applicable tax year. Each company now has a MEGA analyst with whom they interact with during the review process. The MEGA analyst is responsible for providing technical assistance to the company and will conduct an on-site technical visit meeting on many occasions. Once the detailed tax credit application is reviewed, the MEDC audit staff will conduct an on-site audit prior to the issuance of their annual tax credit certificate. This on-site audit will include review of actual W-2's and other documents which will verify the information submitted by the company. When audit staff completes the on-site audit, a final MEGA Tax Credit Certificate will be issued if the audit supports issuance of the tax credit.

With the issuance of Executive Directive 2010-2, the Chief Compliance Officer will also review and approve all MEGA Tax Credit Certificates issued after May 1, 2010.

With these changes in place, the MEDC has addressed the salient issues identified in the Auditor General's performance audit related to the MEGA Tax Credit program and audit process.

The remainder of this paper addresses some of the specific audit findings and comments made during recent legislative hearings to make sure interested parties have a full understanding of the MEGA program.

<u>On the Audit Showing Huge Issues and Hundreds of Millions of Dollars Likely Improperly Claimed</u>

While the OAG report is technically true that as they state as much as "34.8% of the $350.2 million of company reported wages "potentially" did not meet the criteria for a tax credit..." this does <u>not</u> mean that it is a measure of the state's likely exposure to tax fraud, or false claims by Michigan businesses which have received MEGA tax credits. Indeed, even if every company filing a tax credit report for this review period made false, misleading or inaccurate claims, the total maximum exposure to the state is $2.6 million, not "hundreds and hundreds" of millions as was implied in the Senate hearing. Further, for this $2.6 million to be the exposure, implies every claimant is inflating jobs numbers, tax claims and risking jail time. In a word, nonsense.

Based on an MEDC report filed and submitted to the Legislature on May 1, 2009 by the MEDC, audits conducted in early 2009 of a representative sample of 2006 and 2007 MEGA jobs claims showed between company reported jobs created and actual audited jobs created was actually an under-reporting of roughly 1.75%. In other words, companies created slightly more jobs than they reported. For the jobs retention MEGAs, companies over-reported job retained by a scant 0.64%.

As stated above, the backbone of any tax system and, frankly, society, is the presumption of honesty and integrity. These data clearly support that presumption. Finally, we take great umbrage to the comments, remarks and tone of the Senate hearing which basically accused well established and respected Michigan businesses and the MEDC of colluding to commit tax fraud.

Annual Wages

One issued raised was the MEDC's policy to allow the use of annualized wages in the first ramp-up years. It should be noted that the MEDC has had a policy allowing for the use of annualized wages since the MEGA program began. It should also be noted that the average weekly wage requirement is not a statutory requirement and was established by the MEGA in order to hold companies to a higher standard than what was required in the MEGA Act. The entire concept of an average weekly wage is based on MEGA policy so it would seem appropriate to then allow a policy on how to calculate the average weekly wage. The audit finding in this case was not related to the use of the alternative annual wage calculation, but rather to the language in our agreements which did not specifically reflect this alternative method. The MEDC is adding language to the MEGA agreements to address this finding.

Any reference that the MEDC changes policy to benefit companies on a whim or that the MEDC coaches companies to submit inaccurate or misleading data is not accurate and does not reflect the integrity and professionalism of the people working in this program and also does not accurately reflect on the integrity and honesty of the hard working people whose businesses have earned MEGA Tax Credits.

Audit Process

As outlined above, the MEDC has taken steps to incorporate changes and improvements to processes and/or documents to in order to gather all the necessary data from companies receiving MEGAs. We continue to work with the companies that have yet to finalize their audits in order to gather all required information. With the new pre-audit process this information will be collected prior to the issuance of a MEGA tax credit certificate and should eliminate the need for future post audit reviews.

For the audit of all the remaining 2006, 2007, 2008 and 2009 tax credits, the MEDC has fully implemented the recommendations of the auditor general and any variance of credits are being submitted to Treasury as indicated previously. It should also be noted that the MEGA statute has never and does not now require tax credit certificates to be audited.

Since 2006, the MEDC on behalf of MEGA took it upon itself to begin the audit program and has been performing audits to verify tax credit claims. It also should be noted that only Act 261 of 2008 has the Legislature mandated the MEDC to do jobs audits. And, this requirement was dropped from the 2009 MSF Appropriations Act.

Business Activity Credit (BAC)

The MEDC did review all the companies identified in finding #3 in the Auditor General Performance Audit and determined that the total variance for all BAC credits for those companies was just over $24,000 which represents 2% of the total BAC tax credits claimed. Those amounts have been reported to Treasury and all other audits being conducted for 2006 and 2007 tax years will include an audit of the BAC. The BAC was eliminated – at the request of the MEDC - with the repeal of the Single Business Tax and is no longer available as part of a MEGA tax credit.

Performance Based Credit

We want to continue to remind people and emphasize that MEGA tax credits are performanced based. If a company does not meet the terms of their credit agreement they do not receive any tax credits. It is that simple. Companies are not given money up front. They must complete their project, continue to meet their jobs requirements and meet all other requirements in order to receive the tax credits.

Actual Jobs Created vs. Announced Jobs Created

There seems to be a fascination with this comparison for companies that have received MEGA Tax Credits. The MEDC is willing and has provided this data myriad times. Each and every MEGA tax credit agreement has a minimum and maximum number of jobs related to the MEGA. Again, if a company does not meet the minimum jobs requirements, they do not receive a credit, so every tax credit issued will at least meet that minimum job requirement. The maximum job number is the level of jobs which will be created once the project is fully operational and typically has been the jobs number reported in a press release since the program began in 1995. This maximum job number may not be intended to be met until several years into a project due to market conditions and company business decisions. People should remember that every job created under the MEGA program benefits Michigan because it was not created in another state. To assert a project is not successful because a company "promised" 300 new jobs, but in fact only created 250 new jobs, is wrong headed. They still created 250 new jobs and surely the Michigan citizens working in those positions feel like they are part of a successful project.